(3)

No. 92-1074

In the

Supreme Court of the United States

October Term, 1992

JOHN HANCOCK MUTUAL LIFE INSURANCE COMPANY,

Petitioner,

vs.

HARRIS TRUST AND SAVINGS BANK, As Trustee of the Sperry Master Retirement Trust No. 2,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENT

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BRIEF FOR RESPONDENT

PRELIMINARY STATEMENT

Respondent Harris Trust and Savings Bank, as Trustee of the Sperry Master Retirement Trust No. 2 (and its successor the Unisys Master Trust) (the "Trustee"),[1] submits this brief in opposition to those of Petitioner John Hancock Mutual Life Insurance Company ("Hancock"), and *amici* the United States of America, filed on behalf of the Department of Labor (the "DOL"), the State of New York and the Commonwealth of Massachusetts (the "Insurance Commissioners"), the American

[1] The "Trustee" refers to Sperry Corporation and its predecessors from 1941 until May 1, 1978, Chase Manhattan Bank, N.A. from 1978 until October 1, 1987 and, its successor, Harris Trust and Savings Bank thereafter. Harris Trust and Savings Bank is acting as party to this appeal only in its capacity as Trustee of the Plan and is not otherwise affected by the outcome of this litigation. The Bank of Montreal is a parent of Harris Trust.

Council on Life Insurance ("ACLI"), and the Life Insurance Counsel of New York ("LICONY").[2]

This case presents the question of whether the fiduciary protections of the Employee Retirement Income Security Act of 1974, 29 U.S.C. §1001 *et seq.* ("ERISA"), extend to pension plan assets deposited in insurance company general accounts. In this case, the Sperry Retirement Program and its successor, the Unisys Pension Plan (the "Plan"), deposited funds with Hancock under a group annuity contract, GAC 50. While a portion of the funds held under GAC 50 support guaranteed benefits for Plan beneficiaries, a significant portion of GAC 50's assets (the "free funds") support no benefits whatsoever. With respect to the free funds, Hancock is acting as an investment manager and not as an insurer. The exemption from ERISA's fiduciary provisions only extends, and was intended by Congress only to extend, to the portion of GAC 50's assets that supports guaranteed benefits.

STATEMENT OF THE CASE

The Plan is a defined benefit plan under which benefit levels are established by the Plan sponsor[3] and are based upon years employed and income earned. The benefits are funded through a variety of investment vehicles, including GAC 50. When GAC 50 was originally entered into by the parties as of March 1, 1941, the contract provided for the annual purchase of individual deferred annuities from Hancock for each eligible employee, with contributions paid to Hancock by Sperry and deposited in Hancock's general account (J.A. 84, ¶¶ 5-7).[4]

[2] These briefs are cited below, respectively, as follows: "Hancock at ____"; "U.S. at ____"; "NYMA at ____"; "ACLI at ____"; and "LICONY at ____."

[3] The Plan sponsor was Sperry Corporation and its predecessor, Sperry Rand Corporation, until November 12, 1986, and Unisys Corporation thereafter (collectively, "Sperry").

[4] References to the pages of the Joint Appendix, the Appendix to the Petition for a Writ of Certiorari, the Appendix to Hancock's Brief and the Joint Appendix submitted to the Second Circuit are cited at "J.A. ____," "P.A. ____," "H.A. ____," and "S.C.A. ____," respectively.

This type of contract was typical for its time. However, as competition between banks and insurance companies for investment of pension monies increased, the insurance industry developed more flexible contracts. *See generally*, D.McGill & D. Grubbs, *Fundamentals of Private Pensions* 492, 550-51, 562-64 (6th Ed. 1989). Consistent with this phenomenon, as of January 1, 1968, GAC 50 was converted from a deferred annuity to a Retrospective Immediate Participation Guarantee ("Retro-IPG") form of contract (the "1968 amendment") (J.A. 87, ¶ 23). The deferred annuities purchased prior to January 1, 1968 were cancelled and the assets supporting them were placed in a Pension Administration Fund (the "PA Fund") maintained by Hancock within its general account (J.A. 88, ¶25; J.A. 89, ¶32; J.A. 117, 126-72).

In its Retro-IPG form, net investment income from Hancock's general account was directly credited to GAC 50's PA Fund on an annual basis (J.A. 88). The amount credited depended upon Hancock's general account investment performance and the allocation of that performance to the PA Fund (*Id.*).[5] The 1968 amendment required that the PA Fund be maintained at a level sufficient to meet the Liabilities of the Fund ("LOF") as computed by Hancock. LOF is the contractual reserve for the benefit obligations guaranteed by Hancock. For the pre-1968 cancelled annuities, LOF was computed assuming investment rates of 2½ or 3%, depending upon when the benefits were first guaranteed. GAC 50 required that the PA Fund balance be maintained at a minimum operating level of at least 105 percent of LOF (J.A. 88-89). The amount in the PA Fund in excess of this minimum level was referred to by Hancock as "free money" or "free funds" (S.C.A. 250-56).

[5] In the court below, Hancock argued that one way in which investment risk was shifted from the Plan to Hancock was through Hancock's alleged guarantee of the principal balance of GAC 50's PA Fund. Although Hancock has not argued this claim before this Court, the DOL now contends that Hancock provided a guarantee of principal under GAC 50. See U.S. at 3. In fact, Hancock "guaranteed" only that the cumulative net rate of return for GAC 50 since 1968 would not fall below zero (J.A. 88, ¶ 27). In reality, this meant that by 1983, when this action commenced, less than $2 million of the PA

(Footnote continued)

If Sperry failed to maintain the PA Fund balance at or above the minimum level, the PA Fund would be terminated (J.A. 89, ¶ 36). In addition, if the Trustee sought to remove the "free funds" through the contract's transfer provisions, the PA Fund would automatically terminate (J.A. 137; S.C.A. 519, ¶ 10; 559, ¶ 10). Upon termination, the contract would cease to function as a Retro-IPG, the cancelled pre-1968 annuities would be "repurchased" by Hancock using the old 2½ and 3% assumptions, and the contract would revert to its previous deferred annuity form (*id.*; J.A. 89-91). The PA Fund balance in GAC 50 has exceeded the LOF since 1968, although only nominal contributions have been made since that time (J.A. 90, ¶ 38; S.C.A. 656).

The 1968 amendment also contained a provision for additional benefit payments prospectively guaranteed by Hancock. Upon the retirement of an eligible employee, Hancock would determine the amount by which the LOF would increase if the portion of the retirement benefit which accrued after January 1, 1968 were to be guaranteed by Hancock. If GAC 50's PA Fund balance exceeded 105% of the increased LOF, Hancock would guarantee the payment of the additional pension benefits. Pursuant to the 1968 amendment, the purchase rate for these additional annuities was guaranteed until the end of 1972. Thereafter, Hancock had the unilateral right to set the purchase rate for any future annuity guarantees (J.A. 90, ¶ 39).

As of August 1, 1977, GAC 50 again was amended. This amendment converted GAC 50 to a Retrospective Immediate Participation Guarantee/Prospective Deferred Liability form of contract (the "1977 amendment") (J.A. 96-97, ¶ 80). The central feature of the 1977 amendment was the addition of "non-guaranteed benefits." Under the amendment, the Plan was entitled to designate employees to receive non-guaranteed benefits using the free funds in the PA Fund (J.A. 97, ¶ 82). The Plan

Fund's balance, then over $100 million, would have been considered "principal," and by 1984, there was no remaining "principal" because cumulative benefit payments then exceeded the initial starting balance of GAC 50 (J.A. 656, ¶ 9). Thus, in 1983, Hancock would have had to lose at least $100 million of PA Fund monies before its "guarantee of principal" would take effect.

remained ultimately responsible for the pension liability to such individuals; it did not shift the payment risk to Hancock (J.A. 240-49).

In addition, although pre-1968 guarantees would remain in place under the 1977 amendment, benefit accruals after January 1, 1968 for those employees who had not yet retired would not be guaranteed by Hancock (J.A. 96-97, ¶ 80). Although the Plan could request that Hancock establish guaranteed benefits in addition to those already guaranteed, it has never done so (J.A. 97, ¶ 81). Under the 1977 amendment, Hancock continued to have the unilateral right to set the purchase rate for any additional benefits guaranteed under the contract.

Hancock paid non-guaranteed benefits on a monthly basis through June of 1982, when it gave notice that it would no longer pay any non-guaranteed benefits (J.A. 97, ¶¶ 83-84). Also during 1982, Hancock announced that it would no longer permit the Plan to use an informal "rollover" facility to withdraw any portion of the "free funds" in the PA Fund (J.A. 96, ¶¶ 77-79). Thus, by 1983 the Plan had only one avenue available to withdraw these "free funds" for Plan purposes — it could request a complete transfer of all such funds.[6]

Such a transfer, however, would allow Hancock automatically to terminate the PA Fund, thus triggering the "repurchase" of the old pre-1968 deferred annuities and permitting Hancock to hold the bulk of the assets associated with "guaranteed" benefits until either the last retiree or beneficiary died or was no longer entitled to annuity payments (J.A. 137; S.C.A. 519, ¶ 10; S.C.A. 559, ¶ 10; J.A. 89-91, ¶¶ 33, 36, 37, 40 and 42). The low investment rate assumptions used to price the "repurchased" annuities made this alternative prohibitively expensive, effectively preventing the Plan from using the "free funds" in the PA Fund for any pension purposes.

On July 20, 1983, the Trustee commenced this action. In its amended complaint, filed in 1984, the Trustee alleged that Hancock was an ERISA fiduciary as to the PA Fund. The Trustee

[6] Prior to an amendment to GAC 50 in 1988, GAC 50 did not contain any mechanism for a partial withdrawal of "free funds" (J.A. 109-263).

sought to recover the excess funds improperly withheld by Hancock, the losses resulting from Hancock's breach of fiduciary duties under ERISA and common law,[7] the profits made by Hancock using Plan monies, and damages in an amount to be determined at trial. The amended complaint also sought the removal of Hancock as fiduciary, judgment enjoining Hancock from further violations of its duties, and other relief (J.A. 49-71).

As of 1983, there was $18 million in free funds in the PA Fund and by 1988, the free funds had grown to more than $53 million (S.C.A. 457; S.C.A. 561). During 1988, on the eve of the filing of summary judgment motions on the issue of whether Hancock was an ERISA fiduciary, Hancock agreed to a contract amendment which permitted the Trustee to transfer "free funds" out of Hancock's general account without triggering the termination of the PA Fund and Hancock's "repurchase" of the pre-1968 deferred annuities at confiscatory prices (the "1988 amendment") (J.A. 109-263; S.C.A. 519, ¶ 10; S.C.A. 559, ¶ 10; S.C.A. 561).[8] Pursuant to the 1988 amendment, the Trustee transferred nearly $53 million out of the PA Fund on November 1, 1988 (S.C.A. 561).[9]

[7] Such violations included Hancock's use of plan assets to subsidize other lines of business and to attract new business, all at the expense of older pension customers such as the Plan. To cite but one example, Hancock admittedly reduced the rate of return on older contracts such as GAC 50 in order to artificially raise the rate of return on newly-issued contracts during their first two years (S.C.A. 1064-87, ¶¶ 9-14; J.A. 94, ¶¶ 60-62).

[8] Surprisingly, Hancock insinuates that, prior to 1988, the Trustee had the right to freely transfer "free funds" out of GAC 50's PA Fund to other pension plan funding vehicles. Hancock at 9, n. 18. While noting that such a transfer would be subject to a market value adjustment which the Plan allegedly considered "uneconomical," U.S. at 5, the DOL also appears to believe that the Trustee was free to request a transfer of GAC 50's "free funds." *Id.* As noted above, the transfer provision described by Hancock *did not exist* prior to 1988.

[9] The transfer mitigated future damages resulting from Hancock's refusal to allow the excess funds to be withdrawn from the PA Fund or used to pay non-guaranteed benefits. The transfer did not ameliorate the substantial damages sustained to that point by the Plan as a result of Hancock's management and control over such excess funds, or the damages flowing from Hancock's self-dealing and over-compensation with respect to GAC 50 as a whole.

In two separate opinions, the district court granted summary judgment dismissing the Trustee's ERISA fiduciary claims, *Harris Trust and Sav. Bank v. John Hancock Mut. Life Ins. Co.*, 722 F. Supp. 998 (S.D.N.Y. 1989) (P.A. 21-62) ("*Harris I*"), and dismissing the contractual and other common law claims. *Harris Trust and Sav. Bank v. John Hancock Mut. Life Ins. Co.*, 767 F. Supp. 1269 (S.D.N.Y. 1991) (P.A. 63-87) ("*Harris II*"). On appeal, the court below reversed with respect to the dismissal of the Trustee's ERISA claims relating to Hancock's handling of the "free funds" in the PA Fund. *Harris Trust and Sav. Bank v. John Hancock Mut. Life Ins. Co.*, 970 F.2d 1138 (2d Cir. 1992) (P.A. 1-18).[10]

The Second Circuit held that the "free funds" in Hancock's general account are "plan assets" under ERISA, and that Hancock is an ERISA fiduciary to the extent that it has exercised authority or control with respect to the management and investment of such funds. The court of appeals rejected Hancock's claims that GAC 50 was a "guaranteed benefit policy" in its entirety and that the "free funds" were exempt from plan asset treatment. The court concluded that, until the "free funds" were used by the Plan to purchase guaranteed benefits, Hancock was managing assets of the Plan as to which it had provided no guarantees. The court reasoned that it was not significant that these assets were held in Hancock's general account in view of "Hancock's discretionary authority over the non-guaranteed phase of the contract." P.A. 10-11. The Second Circuit concluded that Hancock:

> has maintained funds that were not converted to fixed, guaranteed obligations but instead were subject to fluctuation based on the insurer's investment performance. But the statute defining "guaranteed benefit policy," as noted previously, refers only to that phase of the contract in which the insurer is obligated to guarantee fixed benefits to plan participants. *To the*

[10] The court affirmed that portion of the district court's opinion which concluded that the funds in the PA Fund associated with benefits guaranteed by Hancock were not "plan assets," and that Hancock was not an ERISA fiduciary with respect to those funds.

extent that the insurer engages in the discretionary management of assets attributable to that phase of the contract which provides no guarantee of benefit payments or fixed rates of return, it seems to us that the insurer should be subject to fiduciary responsibility. See 29 U.S.C. § 1002(21)(A).

P.A. 10. (emphasis added).

SUMMARY OF ARGUMENT

ERISA is a comprehensive statute designed to protect employee pension benefits. *Nachman Corp. v. Pension Benefit Guaranty Corp.*, 446 U.S. 359, 361, *reh'g denied*, 448 U.S. 908 (1980). In order "to ensure that employee pension expectations are not defeated," ERISA established a variety of protective rules, including fiduciary standards for pension plan managers. *Alessi v. Raybestos-Manhattan, Inc.*, 451 U.S. 504, 510 n.5 (1981). The fiduciary rules impose a high standard of care and prudence on persons who exercise authority or control over the management or investment of pension plan assets. 29 U.S.C. §1104.

Insurance companies, like any other individual or entity which exercises authority or control over the management or investment of pension plan assets, are subject to the fiduciary standards of ERISA. Congress recognized, however, that the fiduciary protections afforded to pension plans and their participants are not necessary to the extent that an insurer has assumed the investment risk with respect to pension plan assets. Thus, in §401(b)(2) Congress provided a narrow exception to the application of the fiduciary rules of ERISA.

The Second Circuit correctly relied upon the plain meaning of the language adopted by Congress and the applicable legislative history in reaching its conclusion that Hancock is a fiduciary with respect to GAC 50's "free funds." By including within §401(b)(2)(B) the limiting phrase "to the extent," Congress clearly intended to create safe harbor treatment only for that portion of an insurance policy or contract providing benefits "the amount of which is guaranteed by the insurer." 29 U.S.C. §1101(b)(2). This language restricts §401(b)(2)'s exemption to

those plan assets actually used to purchase a fixed amount of guaranteed benefits, and not, as Hancock and *amici* claim, to plan assets which may at some future date be used to purchase an indeterminate amount of guaranteed benefits. The language of §401(b)(2) compels the conclusion that Congress chose to apply ERISA's fiduciary rules to investment managers, including insurance companies, when their investment of plan assets produced variable benefit payments to beneficiaries *or* a variable investment return to a plan.

The Second Circuit's decision is supported by the well-reasoned decision of the Seventh Circuit. *Peoria Union Stock Yards Co. Retirement Plan v. Penn Mut. Life Ins. Co.*, 698 F.2d 320, 327 (7th Cir. 1983) ("*Peoria*"). Relying on established precedents of this Court and the plain language of the Act, the Seventh Circuit's interpretation of §401(b)(2) gives effect to the obvious intent of Congress to provide a limited exemption for funds associated with guaranteed benefits.

The legislative history also makes clear that the test for determining fiduciary status is not solely whether pension funds are held by an insurer in its general account or in a separate account. On the contrary, the Conference Committee rejected explicit language which would have immunized all general account contracts from ERISA's fiduciary rules. Instead, the appropriate test is whether the investment risk has been assumed by the insurer, or whether the investment risk, as here, remains with the Plan. In addition, Hancock and *amici*'s claims to the contrary notwithstanding, ERISA's legislative history makes clear that Congress anticipated the disruptions that the statute would cause in the insurance industry.

The position advanced by the DOL is misguided. The DOL has ignored the language of the statute as well as Congress's mandate to construe exemptions to its remedial provisions narrowly. Moreover, the DOL's claims that it has taken a consistent position with respect to this issue and that the insurance industry developed "settled expectations" as a result are simply not borne out by the record. From its "Interpretive Bulletin 75-2 Relating to Prohibited Transactions" and various Advisory Opinions issued

over the years, through the issuance of the Plan Asset Regulation in 1986, and climaxing in the DOL's refusal to file a brief on this issue when requested to by the court below, the DOL has often supported the Trustee's position or, at the very least, acted inconsistently.

In order to escape the clear language of ERISA and the obvious intent of Congress, Hancock and *amici* claim that conforming to both state law and ERISA fiduciary rules would be impossible. These claims are irrelevant and, in any event, do not bear scrutiny. The issue before this Court is the interpretation of §401(b)(2), not its implementation. The proper forum for the debate on how best to regulate general account products under ERISA is the DOL's regulatory process. At that time, issues concerning class exemptions from the prohibited transaction rules, the previous experience with insurance company pooled separate accounts and the usefulness of segmentation can be weighed on a full record.

Finally, Hancock and *amici* claim that to the extent ERISA brings certain general account contracts within its reach, ERISA is pre-empted by state law. The DOL properly rejects this theory. Neither ERISA's Savings Clause nor the McCarran-Ferguson Act assist Hancock. The law is clear: where state insurance law and ERISA do not conflict, insurers are subject to dual regulation; where the two collide, ERISA alone survives.

ARGUMENT

I.

SECTION 401(b)(2) REQUIRES A HOLDING THAT HANCOCK IS AN ERISA FIDUCIARY WITH RESPECT TO THE FREE FUNDS IT HOLDS UNDER GAC 50

A. *The Plain Language and The History of §401(b)(2)(B) Support The Second Circuit's Interpretation*

> [A] person is a fiduciary with respect to a plan to the extent . . . he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets . . . .

29 U.S.C. §1002(21)(A). Hancock's status as a fiduciary turns upon whether pension funds invested in its general account — as to which Hancock unquestionably exercises sufficient control and authority to render it a fiduciary— are "plan assets" under ERISA. Although not defined in the statute, the scope of "plan assets," so far as is relevant here, is evident from the statutory scheme. But for §401(b)(2)'s "safe harbor," pension funds invested in insurance company contracts like GAC 50 would remain plan assets subject to ERISA's fiduciary rules. *Peoria*, 698 F.2d at 326.

Section 401(b)(2) provides a limited exception from ERISA's fiduciary rules for insurance companies that issue "guaranteed benefit policies":

> In the case of a plan to which a guaranteed benefit policy is issued by an insurer, the assets of such plan shall be deemed to include such policy, but shall not, solely by reason of the issuance of such policy, be deemed to include any assets of the insurer.

29 U.S.C. §1101(b)(2). Section 401(b)(2)(B) defines "guaranteed benefit policy" as "an insurance policy or contract *to the extent that* such policy or contract provides for benefits the amount of which is guaranteed by the insurer." 29 U.S.C. §1101(b)(2)(B) (emphasis added).

Hancock and *amici* contend that §401(b)(2) exempts all general account contracts from ERISA's fiduciary rules.[11] Hancock at 13; ACLI at 3; LICONY at 11; NYMA at 8; U.S. at 13. This interpretation has no support in the language of the statute. Such an interpretation finds support only in the Senate bill which explicitly exempted *all* assets held in general accounts from

[11] Under ERISA all pension plan assets held in separate accounts are "plan assets" and therefore subject the insurance company to ERISA's fiduciary duty provisions. *See* 29 U.S.C. §1101(b)(2)(B).

ERISA's fiduciary duty provisions.[12] This early draft provision, however, was deleted by the Conference Committee and replaced by the more limited "guaranteed benefit" exemption. 29 U.S.C. §1101(b)(2). The only rational interpretation of the Conference Committee's rejection of the Senate's explicit exemption for general account assets is that it intended a different result. The Conference Committee compromised between the Senate's total exemption and the House's lack of any exemption by taking the intermediate position reflected in §401(b)(2)(B).[13]

In sum, the language and history of §401(b)(2) demonstrate that Congress did not intend to establish a blanket exemption for all assets held in insurers' general accounts. Rather, Congress intended to distinguish between pension funds supporting "guaranteed benefits" and all other pension monies held by insurance companies.

B. *"To The Extent" Is A Term of Limitation Which Must Be Given Effect In Interpreting §401(b)(2)(B)*

The critical phrase in §401(b)(2)(B) is "to the extent," a phrase that is also found in ERISA's definition of fiduciary. 29 U.S.C. §1002(21)(A). As this Court has stated, "language used in one portion of a statute . . . should be deemed to have the same meaning as the same language used elsewhere in the statute . . . ." *Mertens v. Hewitt Associates*, No. 91-1671, 1993 U.S. LEXIS 3742, at *20 (June 1, 1993); *Sorenson v. Secretary of the Treasury*, 475 U.S. 851, 860 (1986).

ERISA defines persons as fiduciaries only "to the extent" that they engage in certain activities. 29 U.S.C. § 1002(21)(A).

[12] The Senate bill provided that the fiduciary provisions would not apply to "funds held by an insurance carrier unless that carrier holds funds in a separate account." S.4, 93d Cong., 1st Sess. §511 (1973), reprinted in, 1 Legislative History of ERISA at 170 (Comm. Print 1976).

[13] Courts have long recognized that "statutes are frequently the product of compromise, and a legislative compromise would be undone if a court enforced the maximum position of one of the negotiating factions." *Harmon v. Teamsters*, 832 F.2d 976, 979 (7th Cir. 1987), *citing Rodriguez v. United States*, 480 U.S. 522 (1987). Hancock and *amici* ask this Court to enforce the Senate position, when the enacted language shows clear evidence of a compromise.

Numerous circuit courts, in defining the scope of the fiduciary definition, have interpreted the phrase "to the extent" as one of limitation.[14] "[T]he inclusion of the phrase 'to the extent' in §1002(21)(A) means that a party is a fiduciary only as to the activities which bring the person within the definition. The statutory language plainly indicates that the fiduciary function is not an indivisible one." *Coleman v. Nationwide Life Ins. Co.*, 969 F.2d at 61. The phrase "to the extent" thus creates a division between a single entity's functions — those which give rise to fiduciary obligations and those which do not.

Section 401(b)(2)(B) demands the same approach. A contract or policy of insurance is divisible and is only exempt from ERISA's fiduciary duty provisions "to the extent" it "provides for benefits the amount of which is guaranteed by the insurer." GAC 50 clearly is not a "guaranteed benefit policy" with respect to the free funds Hancock holds under the contract. Indeed from 1977 to 1982, those funds were used to pay "*non-guaranteed benefits*," a term coined by Hancock and used in the contract (J.A. 241).

The substitution by the district court and Hancock of the word "if" for the phrase "to the extent" improperly eliminates this important limitation from §401(b)(2)(B). *See Harris I*, P.A. 57 ("Congress did not intend to hold an insurer to a fiduciary duty *if* the contract . . . provides for fixed benefits to the plan beneficiary.") (emphasis added).[15] A similar substitution of "if"

[14] *Coleman v. Nationwide Life Ins. Co.*, 969 F.2d 54, 61 (4th Cir. 1992), *cert. denied*, 1993 U.S. LEXIS 929 (1993); *Belade v. ITT Corp.*, 909 F.2d 736, 738 (2d Cir. 1990); *Hozier v. Midwest Fasteners, Inc.*, 908 F.2d 1155 (3d Cir. 1990); *Lea v. Republic Airlines, Inc.*, 903 F.2d 624 (9th Cir. 1990); *F.H. Krear & Co. v. Nineteen Named Trustees*, 810 F.2d 1250 (2d Cir. 1987); *Sommers Drug Stores Co. Employees Profit Sharing Trust v. Corrigan Enter., Inc.*, 793 F.2d 1456, 1459, *reh'g denied*, 797 F.2d 977 (5th Cir. 1986), *cert. denied*, 479 U.S. 1034 (1987); *Leigh v. Engle*, 727 F.2d 113 (7th Cir. 1984); *see also* 29 C.F.R. §2509.75-8 (D-4) (1992).

[15] Hancock reorders the syntax of §1101(b)(2) and omits any language of limitation, in the process changing its meaning to achieve the same result. *Cf.*

(Footnote continued)

for "to the extent" in §3(21)(A) would render invalid all of the decisions cited above. Clearly, neither result was intended by Congress. The statute only gives safe harbor "to the extent that such policy or contract provides for benefits the *amount of which is guaranteed* by the insurer." 29 U.S.C. §1101(b)(2)(B) (emphasis added).[16]

The DOL argues that "to the extent" was intended to distinguish between fixed and variable annuities sold from general accounts. U.S. at 20. Aside from the absence of any support for this interpretation in the statute, the insurance industry does not (and did not in 1974) sell variable annuities from general accounts. In fact, relevant state law forbids the sale of variable annuities from general accounts. *See* Hancock at 19, n. 30, 20, n. 31; ACLI at 11-12, n. 16. The DOL thus relegates §401(b)(2) to the realm of a statutory exemption aimed at a practice which did not exist at the time, and which is forbidden under state insurance laws.[17]

Hancock at 4 ("In section 401(B)(2) . . . Congress expressly declared that an insurer's assets held under a 'policy or contract that provides for benefits the amount of which is guaranteed by the insurer' are not plan assets").

[16] The construction of "to the extent" argued by Hancock and the *amici* would also run counter to the insurance guaranty schemes of New York and Massachusetts. Massachusetts explicitly excludes from its guaranty law's protection

> any annuity contract or group annuity certificate that is not issued to and owned by an individual, except *to the extent* of any annuity benefits guaranteed to an individual by the insurer under any such contract or certificate.

Mass. Ann. Laws, ch. 175, §146(B)(4)(B)(2)(C) (Law Co-op. 1993) (emphasis added); *see also* N.Y. Ins. Law §7703(b)(2) (Consol. 1993). Under Hancock's reading of "to the extent," because GAC 50 *permits* the purchase of additional guaranteed benefits, the entire contract would be entitled to the protection of the Massachusetts guaranty law. Such a reading of the phrase, however, obviously distorts the intention of the Massachusetts legislature, as it does that of Congress.

[17] In defense of this obviously flawed reading of the statute, the DOL contends that "there is no inherent reason why general account contracts could not provide for the payment of variable annuities instead." U.S. at 20. But in fact there is: "[O]nly fixed benefit payments may be made from an insurer's general account. New York law permits the payment of variable benefits, but only from a separate account." NYMA at 4, n.3

C. *With Respect To Its Free Funds, GAC 50 Does Not "Provide For" Benefits the Amount Of Which Is Guaranteed*

Contrary to the Third Circuit's reasoning in *Mack Boring & Parts Co. v. Meeker, Sharkey & Moffitt*, 930 F.2d 267 (3d Cir. 1991) ("*Mack Boring*"), and that of Hancock and *amici*, GAC 50 is a hybrid contract, containing both guaranteed and non-guaranteed elements. Simply because the Trustee could have used the contract's "free funds" to purchase additional "guaranteed benefits" does not render the contract "guaranteed" in its entirety. *See* Hancock at 26-27; U.S. at 16-17, 19; ACLI at 19. If sustained, this argument would immunize *all* general account contracts, because virtually all contain some provision for future guarantees in order to comply with state regulations. By Hancock's and *amici*'s reasoning, all an insurance company need do to immunize itself from ERISA is to include in all of its pension investment offerings an annuity purchase option, at a price to be determined by the insurance company at the time of the exercise of the option. Thus, the insurers would have the benefit of §401(b)(2) without assuming any risk.

The language of §401(b)(2), however, conflicts with this facile interpretation: even though GAC 50 may have an optional purchase provision, the *amount* of benefits which might at some future date be guaranteed by Hancock is unpredictable, and depends solely upon Hancock's skill as an investor. The only benefit payments "the *amount* of which is guaranteed by [Hancock]" are those benefits guaranteed under GAC 50 prior to its amendment in 1977. GAC 50 is a guaranteed benefit policy only as to those guaranteed benefits.

Moreover, it is clear from its brief that the DOL misunderstands a critical feature of GAC 50: with respect to GAC 50's free funds, Hancock did not " 'provide[] *a guaranteed price structure* that the employer can unilaterally decide to take advantage of at any time that it feels the probable future course of investment, mortality, and expense risks will be such that it will be to its advantage to shift the risk to the life insurance company.' " U.S. at 15, *quoting* K. Black & H. Skipper, *Life*

Insurance, at 497 (11th Ed. 1987); *see also* Hancock at 10. While the contract contains provisions permitting the Trustee to request further guaranteed benefits, Hancock had the option to unilaterally change the price for such annuities at any time after 1972.[18] Thus, a linchpin of the DOL's reasoning is simply incorrect.

By accepting Hancock's and the ACLI's mischaracterization of GAC 50 as a contract in which "substantial risk" has been shifted, at least potentially, to Hancock, the DOL has ignored or misunderstood the realities of this form of investment vehicle. In fact, the only reason that an optional guaranteed purchase provision still appears in GAC 50 is that Hancock stated that such a provision was necessary to meet the requirements of Massachusetts law (S.C.A. 1105-06, ¶ 9; S.C.A. 1243).[19] Professor McGill also acknowledges that optional purchase provisions in IPG contracts like GAC 50 are no more than a "pretense." D. McGill & D. Grubbs, *Fundamentals of Private Pensions* 564 (6th Ed. 1989); *see also id.* at 492.[20]

[18] When GAC 50 was amended in 1968, the contract established a rate for purchases of additional guaranteed benefits for five years, or until 1972. After 1972, Hancock had the unilateral right to modify the rates in the contract (J.A. 90, ¶ 39).

[19] Hancock's own expert, William Dreher, explained more broadly the phenomenon of optional guaranteed benefit purchase provisions being required in investment contracts:

> [T]here is a legal necessity that the contract qualify as a product that is offered by an insurance company under the applicable state laws, but . . . the principal business purpose being achieved by the buyer relates to an assumption about the . . . success of the insurance company's management of those plan assets.

S.C.A. 595-96.

[20] The Insurance Commissioners' position does not reflect the current realities of these types of contracts. They contend that, "fundamentally, purchasers of insurance company group annuity contracts are purchasing insurance products that guarantee the payment of retirement benefits to plan participants . . . . They are not, and have never been, purchasing an investment advisory service subject to federal regulation." NYMA at 20. This statement cannot be reconciled with the facts, nor with New York's and Massachusetts's refusal

(Footnote continued)

The DOL's adoption of Hancock's and the ACLI's position also ignores this Court's analysis of the hybrid nature of investment vehicles such as GAC 50. *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967) ("*United Benefit*"). There, as here, the contract in issue contained an optional annuity purchase provision which permitted the purchaser to convert his interest in a separate account "Flexible Fund" into a life annuity. This Court concluded that, even with this feature and a "guarantee that a certain amount of fixed-amount payment life annuity will be available at maturity," the contract was an investment contract within the scope of the Securities Act, and not an exempt insurance contract. *Id.* at 206.

As this Court noted, the "fixed-payment benefits are adjusted to reflect the number of dollars available, as opposed to the conventional annuity where the amount available is planned to reflect the promised benefits." *Id.* at 208. Because the amount of "free funds" available in the event the Plan chose to purchase additional guaranteed benefits is entirely dependent on Hancock's investment performance, GAC 50 is in this respect no different than the contract under review in *United Benefit*. *See Peoria*, 698 F.2d at 327.

In short, to permit Hancock and other insurers to evade ERISA regulation of their activities as investment advisors through the pretense of optional annuity purchase provisions, with or without a "guaranteed" pricing structure, would eviscerate the fiduciary provisions of ERISA and should be rejected.

to provide guaranty fund protection to the non-guaranteed portions of pension investments in general accounts. *See* N.Y. Ins. Law §7703(b)(2) (Consol. 1993); Mass. Ann. Laws ch. 175, §146(B)(4)(B)(2)(C) (Law Co-op 1993). Moreover, the claim that fixed rate annuities are fundamentally insurance products was squarely *rejected* in *In re New York State Association of Life Insurance Underwriters, Inc. v. New York State Banking Dep't*, No. 66903, 1993 N.Y. App. Div. LEXIS 5489 (June 3, 1993), at the behest of New York's Attorney General. In that case, New York successfully argued that such annuities are "*financial investment instruments* which are very similar in character to other financial instruments which banks are allowed to offer, including debt instruments and certificates of deposit." *Id.* at *6 (emphasis added).

D. *The Use of the Term "Benefit" in §401(b)(2) Supports the Second Circuit's Reading*

Hancock seeks to find significance in Congress's use of the term "benefits." Because the term "benefit" refers only to individual benefits paid to beneficiaries, Hancock claims ERISA's fiduciary rules are applicable *only* when benefits payable to plan participants and beneficiaries from insurance company general accounts are variable. Based on this flawed reasoning, Hancock concludes that the variable nature of GAC 50's investment return to the Plan is irrelevant, because benefit payments to retirees and beneficiaries already established under GAC 50 will not vary.

However, §401(b)(2) is not structured in the way that Hancock suggests. As the court below observed, the *only* funds entitled to safe harbor treatment are those securing guaranteed payments to beneficiaries. It follows, therefore, that *all* funds not associated with guaranteed benefits, whether used to provide variable benefit payments to beneficiaries *or* variable investment return to a plan, are not exempt. Unless the funds in issue are used to provide guaranteed benefits, narrowly defined, they are "plan assets" subject to ERISA's fiduciary rules.

This interpretation of §401(b)(2) is consistent with the long-held views of the DOL that the investment return to *plans* is as important as the return to beneficiaries. The DOL also has required that neither the beneficiary's nor the Plan's investment return be variable for the investment manager to escape fiduciary treatment. DOL Adv. Opinions 78-8A (March 13, 1978) (H.A. 104) and 83-51A (Sept. 21, 1983) (H.A. 110). *See* Point III, D below. The DOL correctly views plans as standing in the stead of participants and beneficiaries, who depend on the financial soundness of their plans to protect their benefits. U.S. at 22.

E. *ERISA's Treatment of Separate Accounts Does Not Support Petitioner's Contentions Regarding the Treatment of General Accounts*

Hancock and the ACLI argue, and the *Mack Boring* court surmised, that §401(b)(2) was designed by Congress to close a

"loophole" in the statute and ensure that a contract which permitted contributions to both the general account and separate accounts would be an exempt guaranteed benefit policy only "to the extent" that plan contributions were held in the general account. ACLI at 21-22; *Mack Boring*, 930 F.2d at 274. This reading, however, finds no support in the statutory language.

Section 401(b)(2)(B) does *not* state, as the ACLI would have it, that a policy or contract is a guaranteed benefit policy "except to the extent contributions are held in separate accounts" or "to the extent contributions are held in the general account." On the contrary, §401(b)(2) exempts only an insurance policy or contract "to the extent that such policy or contract provides for benefits the amount of which is guaranteed by the insurer." Hancock's and the ACLI's argument is nothing more than a disguised attempt to revive the Senate bill's blanket exemption of all general account assets from ERISA's fiduciary provisions, an approach that was abandoned by the Conference Committee.

The ACLI contends that if the first sentence of §401(b)(2)(B) is interpreted as the Second Circuit held, then the second sentence would be unnecessary. ACLI at 20-21.[21] This is simply incorrect. A coherent reading of the statute suggests that the treatment by Congress of surplus in separate accounts is fully consistent with the Second Circuit's decision. Aside from the exemption for "surplus," pension funds held in separate accounts are always treated as plan assets under ERISA. This, of course, is consistent with Congress's purpose of requiring fiduciary compliance when pension plan investments are at risk.

The Second Circuit's reading of §401(b)(2)(B) does not render any portion of the language superfluous. While the first sentence of the subsection was designed to *limit* the exemption to that portion of a contract under which benefit payments were *guaranteed*, the second sentence was necessary to ensure that

[21] The second sentence of § 401(b)(2) provides that the term "guaranteed benefit policy . . . includes any surplus in a separate account, but excludes any other portion of a separate account." 29 U.S.C. §1101(b)(2)(B).

the insurance company's own "seed" money deposited in separate accounts would not be swept within ERISA's reach.[22] Furthermore, the second sentence clarifies that Congress did not consider any separate account arrangements to qualify as "guaranteed benefit policies." The ACLI, however, distorts this extremely limited concession into an exemption which would bring *all* general account contracts, whether or not *any* benefits are actually guaranteed, within its ambit.[23]

F. *Following a Long Line of Supreme Court Decisions, the Seventh Circuit Correctly Read §401(b)(2) As Exempting Annuity Contracts Only During Their Annuity Phase*

The Seventh Circuit has also concluded that §401(b)(2) is a narrow exception and cannot be read as a blanket immunity for insurance company general accounts. *Peoria Union Stock Yards Co. Retirement Plan v. Penn Mut. Life Ins. Co.*, 698 F.2d 320, 327 (7th Cir. 1983). *Peoria* involved a general account

[22] The ERISA Conference Report makes this point clearly:

> [I]nsurance companies are to be responsible under the general fiduciary rules with respect to assets held under separate account contracts, and the assets of these contracts are to be considered plan assets (but need not be held in trust). However, to the extent that insurance companies place *some of their own funds* in these separate accounts to provide for contingencies, this separate account "surplus" is not to be subject to the fiduciary responsibility rules.

H. Rep. No. 1290, 93d Cong., 2d Sess. 296 (1974), *reprinted in* 1974 U.S.C.C.A.N. 5038, 5077 (emphasis added) ("ERISA Conf. Rep.").

[23] Surplus in separate accounts is fundamentally different from the "free funds" in GAC 50's PA Fund. Separate account "surplus" is the "seed money" invested by insurance companies to start separate accounts. ERISA Conf. Rep. at 5077; DOL Adv. Opinion 83-38A (July 22, 1983) (LEXIS, Labor library, ERISA file); U.S. at 18, n.10; *see also, e.g.*, N.Y. Ins. Law §4240(a)(3) (Consol. 1993). Such "surplus" is *not* created by the earnings of pension monies held in the separate account. Thus, separate account "surplus" is in no sense analogous to the free funds in GAC 50, which are the assets of the Plan, not of Hancock, and thus should be used as ERISA requires — for the benefit of Plan participants and beneficiaries. 29 U.S.C. §1104(a)(1)(A)(i).

deposit administration contract in which pension funds were deposited in a "DA Fund" and "commingled for investment purposes with the funds of other customers of the insurance company, in much the same way as investments of different investors are pooled in a mutual fund or common trust fund, in order to obtain diversification while minimizing brokerage and management costs." *Id.* at 322. Once an employee retired, annuities were purchased and the purchase price for such annuities was removed from the DA Fund account. The DA Fund no longer received the benefit of the insurer's investment experience on the funds so removed and no payments to beneficiaries were ever made from the DA Fund.

The Seventh Circuit held that while the funds in issue were kept in the DA Fund, the contract was in a variable accumulation phase and did not constitute a "guaranteed benefit policy" because the insurer had investment discretion and the results of that investment discretion would determine the amount of funds available to the pension plan:

> Congress did not want to make an insurance company that sells a standard annuity contract — one that provides "benefits the amount of which is guaranteed by the insurer" — a fiduciary toward the purchaser of the contract. But that is not what Penn Mutual sold here. The pension trustees did not buy an insurance contract with a fixed payout; they turned over the assets of the pension plan to Penn Mutual to manage with full investment discretion, subject only to a modest income guaranty. If the pension plan had hired an investment advisor and given him authority to buy and sell securities at his discretion for the plan's account, the advisor would be a fiduciary within the meaning of the act, and that is essentially what the trustees did during the accumulation phase of the contract with Penn Mutual.

Id. at 327.[24] *Accord Jacobson v. John Hancock Mut. Life Ins. Co.*, 655 F. Supp. 1290, withdrawn pursuant to settlement, 662 F. Supp. 1103, 1112-13 (D. Conn. 1987).

As Judge Posner's analysis in *Peoria* indicated, the decision by Congress to create a narrow exemption from ERISA's fiduciary rules for certain types of insurance contracts was hardly surprising. The Seventh Circuit relied on a long line of cases which analyze the realities of insurance contracts. In *SEC v. Variable Annuity Life Ins. Co. of America*, 359 U.S. 65 (1959) ("*VALIC*"), this Court had held that variable annuity contracts issued by insurance companies are "investment contracts" and not exempt "insurance contracts" under the Securities Act. Similarly, in *SEC v. United Benefit Life Insurance Co.*, this Court rejected an "all-or-nothing" analysis of an insurance contract with an optional fixed annuity purchase provision. 387 U.S. 202 (1967).

This Court concluded that an insurance company product could be broken down into investment and insurance

[24] Hancock attempts to distinguish *Peoria*, arguing that the Seventh Circuit's decision came in the context of a dismissal motion and not summary judgment, impugning the Court's analysis as "casual." Hancock at 25, n. 42. The *Peoria* decision is a reasoned and realistic analysis of the DA Fund contract following the precedents of this Court. Moreover, the Seventh Circuit has consistently adhered to Judge Posner's analysis; his approach continues to play a central role in the Seventh Circuit's analysis of the scope of §401(b)(2). *See, e.g., Associates in Adolescent Psychiatry, S.C. v. Home Life Ins. Co.*, 941 F.2d 561, 568 (7th Cir. 1991) (Easterbrook, J.), *cert. denied*, 112 S. Ct. 1182 (1992) (contract held to be a "guaranteed benefit policy" where investment return announced in advance and guaranteed by the insurer).

The DOL also attempts to distinguish *Peoria*, contending that, under the contract there in issue, "the plan bore the entire investment risk . . ." U.S. at 15, n. 8. In fact, the *Peoria* and *Mack Boring* contracts are the same — both were deposit administration contracts with accumulation and annuity phases. *Compare Peoria*, 698 F.2d at 322-23 *with Mack Boring*, 930 F.2d at 268-69. Although GAC 50, as an immediate participation guarantee contract, takes a slightly different form, in all three contracts the amount available to the pension plan to purchase annuities is solely dependent on the insurance company's skill in investing plan assets during the accumulation phase. Moreover, Hancock has repeatedly stated that the Plan is also "on the risk for the plan experience" under GAC 50 (S.C.A. 271, 285, 293, 316, 333, 350, 366, 382, 399, 428). Again, the DOL's position is based on an incorrect understanding of the contracts at issue.

components, and that, in the "accumulation" phase, the contract in issue was a non-exempt investment contract under the Securities Act:

> First, we do not agree with the Court of Appeals that the "Flexible Fund" contract must be characterized in its entirety. Two entirely distinct promises are included in the contract and their operation is separated at a fixed point in time.

United Benefit, 387 U.S. at 207.

The Court also provided a basis for distinguishing between the insurance and investment aspects of contracts like GAC 50. After analyzing the role of an insurer in pricing and establishing a conventional annuity, the Court noted the distinct difference in the role an insurance company assumes during the accumulation phase:

> The "Flexible Fund" program completely reverses the role of the insurer during the accumulation period. Instead of promising to the policyholder an accumulation to a fixed amount of savings at interest, the insurer promises to serve as an investment agency and allow the policyholder to share in its investment experience.
>
> . . . .
>
> The fixed-payment benefits are adjusted to reflect the number of dollars available, as opposed to the conventional annuity where the amount available is planned to reflect the promised benefits.

Id. at 208. This Court also recognized that the test for determining whether an insurance company product is an "investment contract" or an insurance policy is

> what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect. In the enforcement of an act [such as the Securities Act] it is not inappropriate that promoters' offerings be judged as being what they are represented to be.

Id. at 211, *quoting SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 352-53 (1943).

In assessing whether GAC 50 is in its entirety a "guaranteed benefit policy," the "character given the instrument" by Hancock and the insurance industry is highly relevant. Hancock's own marketing materials and one of its experts characterized IPG contracts like GAC 50 as "investment vehicles." S.C.A. 273, 591-92. According to Hancock's own expert, "investment vehicle" is "a trade term that is used by insurance companies [in selling contracts such as GAC 50] in their efforts to induce pension plan sponsors to do business with them, on the grounds that they will be able to deliver the type of investment strategy or desirable investment result in competition with other providers of investment services." S.C.A. 595. The investment performance of insurance companies is critical to pension plans such as GAC 50 because the pension plan bears all the investment risk with respect to the non-guaranteed portion of the contract. *See, e.g.*, S.C.A. 428.

Although Hancock made certain promises as an "insurer" with respect to GAC 50's guaranteed benefits, its sole role with respect to the "free funds," that is, the accumulation phase of the PA Fund, is as an investment advisor. Indeed, Hancock repeatedly has stated that the Plan is "on the risk for the plan experience." (S.C.A. 271, 285, 293, 316, 333, 350, 366, 382, 399, 428). While the Plan could request that "free funds" be used to purchase further "guaranteed benefits" – at a price, after 1972, within Hancock's sole discretion – these "fixed-payment benefits [would be] adjusted to reflect the number of dollars available, as opposed to the conventional annuity where the amount available is planned to reflect the promised benefits." *United Benefit*, 387 U.S. at 208. Thus, while the Plan may be free to purchase "guaranteed" benefits in the future, the *amount* of such benefits is *not* guaranteed.

The reasoning of this Court in *VALIC* and *United Benefit* consistently has been followed by the courts in analyzing insurance company products under the federal securities laws. *See, e.g, Otto v. Variable Annuity Life Ins. Co.*, 814 F.2d 1127 (1986), *as amended on rehearing*, 814 F.2d 1130, 1141 (7th Cir. 1987), *cert. denied*, 486 U.S. 1026 (1988). It can be presumed that Congress was aware of *United Benefit* and its progeny when ERISA was enacted and intended to incorporate this analysis by using the term "insurance policy or contract" in the definition of "guaranteed benefit policy." *See* 29 U.S.C. §1101(b)(2)(B).

G. *The Interpretation of §401 Proffered By Hancock and* Amici *Violates Basic Canons of Statutory Construction*

The interpretation of §401(b)(2) advanced by Hancock and *amici* violates basic canons of statutory construction. First, their construction contravenes the precept that courts should avoid an interpretation of a statute if it "render[s] any part of it superfluous and does not give effect to all of the words used by Congress." *Beisler v. Commissioner*, 814 F.2d 1304, 1307 (9th Cir. 1987); *see Meloy v. Conoco, Inc.*, 817 F.2d 275, 279 (5th Cir. 1987). The interpretation proffered by Hancock and *amici* renders the phrase "to the extent" meaningless and superfluous.

Second, Hancock's and *amici*'s strained interpretation of §401(b)(2)(B) contravenes the principle that, in construing comprehensive remedial legislation such as ERISA, exceptions must be narrowly construed. *Rodriguez v. Compass Shipping Co.*, 451 U.S. 596, 614, n.33 (1981). ERISA's legislative history explicitly adopts this rule. S. Rep. No. 127, 93d Cong., 1st Sess. at 18, *reprinted in* 1974 U.S.C.C.A.N. 4838, 4854 ("It is intended that coverage under the Act be construed liberally" and "exemptions should be confined to their narrow purpose.")

Unlike Hancock and the ACLI, the DOL does not contend that §401(b)(2) unambiguously exempts all general account contracts from the reach of ERISA's fiduciary provisions. The DOL instead has taken the position that the provision in issue is ambiguous, and acknowledges that the Second Circuit's construction of the exemption "finds support in the statutory text and has some advantages as a matter of policy." U.S. at 12. Nevertheless, ignoring the rule that exceptions to ERISA must be narrowly interpreted, the DOL argues that a broader construction of the exemption should be adopted in order to avoid upsetting the allegedly "settled expectations" of the insurance industry. U.S. at 13. As demonstrated below, the DOL's contentions as to

the "settled expectations" of the insurance industry are belied by the record. *See* Point III, below.

Third, Hancock's construction of the guaranteed benefit policy exemption violates the familiar precept that

> "where Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion."

Russello v. United States, 464 U.S. 16, 23 (1983), *quoting United States v. Wong Kim Bo*, 472 F.2d 720, 722 (5th Cir. 1972). In §401(b)(1), Congress explicitly exempted *all* pension funds invested in mutual funds from ERISA's fiduciary standards. That section reaches "*any* security issued by an investment company registered under the Investment Company Act of 1940." 29 U.S.C. §1101(b)(1). By contrast, §401(b)(2)(B) is narrower and particularized. Congress, perfectly capable of drafting a broad exclusion, chose not to in §401(b)(2)(B).

Hancock appears to argue that sections 401(b)(1) and 401(b)(2) should be construed in the same way, as wholly exempting investments in both mutual funds and general account contracts. Hancock at 16, 21, n. 33; ACLI 14-15. Hancock would have this Court ignore the specific limiting language of §401(b)(2)(B), which obviously has no counterpart in the mutual fund exemption. Congress's expressed rationale for §401(b)(1) was that mutual funds, already subject to federal regulation, should be exempt from ERISA's fiduciary rules. ERISA Conf. Rep., *reprinted in* 1974 U.S.C.C.A.N. at 5077. No similar statement or rationale can be found to support the idea that Congress proposed to adopt a broad exemption for general account contracts.[25]

[25] Hancock is forced to turn to a DOL discussion of an early version of the Plan Asset Regulation, *which was withdrawn* by the DOL, to find a similarly broad expression of the alleged rationale for §401(b)(2). *See* discussion at Point III, C below. In addition, as demonstrated by the *Harris II* decision, summarily dismissing all of the Trustee's state law claims, there is no similarity between SEC regulation of mutual funds and state regulation of general accounts.

II.

ERISA'S LEGISLATIVE HISTORY FULLY SUPPORTS THE SECOND CIRCUIT'S INTERPRETATION OF §401(b)(2)(B)

The legislative history of §401(b)(2) clearly reflects Congressional intent to apply ERISA's fiduciary rules to insurance companies where the investment of plan assets in insurance companies will result in variable investment return. The legislative history also indicates that Congress was aware that its decision would upset accepted insurance company practices, and that Congress included measures within the statute designed to ameliorate the adverse impact of ERISA on the way insurance companies had previously done business.

A. *The Conference Report Demonstrates Congress's Intention to Carve Out a Narrow Exception for Guaranteed Benefits*

The legislative history of §401(b)(2)(B), though relatively sparse, provides significant support for the Second Circuit's interpretation of the statute. The Conference Report unmistakably recognized that a single policy may be separated into guaranteed and non-guaranteed portions for the purpose of determining which funds constitute plan assets:

> If the policy guarantees basic payments but other payments may vary with, e.g., investment performance, then *the variable part of the policy and assets attributable thereto* are not to be considered as guaranteed, and are to be considered as plan assets subject to the fiduciary rules.

ERISA Conf. Rep., *reprinted in* 1974 U.S.C.C.A.N. 5038, 5077 (emphasis added).[26]

[26] The Conference Report further states:

> To the extent that plan assets are held by an insurance company they need not be held in trust. However, to the extent the substitute treats assets held by an insurance company as "plan assets" the insurance company is to be treated as a fiduciary with respect to the plan, and is to meet the fiduciary standards of the conference substitute.

(Footnote continued)

As the DOL acknowledges in its brief, "The Conference Committee's use of the word 'payments' rather than 'benefits' and its reference to the 'variable part of the policy' make more plausible the court of appeals' inference that Congress was thinking of payments to plans rather than payments to plan beneficiaries . . . ." U.S. at 21. Moreover, the Conference Committee's use of the word "benefits," and not "payments" in the statute does not assist Hancock. *See* Hancock at 24, n.40; U.S. at 21. Congress's use of the narrower term "benefits" indicates a purpose to narrowly confine the exemption afforded by §401(b)(2), *i.e.*, the exemption is applicable only to "benefits the amount of which is guaranteed by the insurer," while all other aspects of the contract, including variable payments to beneficiaries *or plans*, are to be governed by ERISA's fiduciary rules.

Furthermore, the Conference Committee's decision to reject the Senate's blanket exemption for general account contracts shows that it "intended to accomplish a different result." U.S. at 20. The Senate bill provided that the fiduciary provisions would not apply to "funds held by an insurance carrier unless that carrier holds funds in a separate account." S.4, 93d Cong., 1st Sess. §511 (1973), *reprinted in* 1 Legislative History of ERISA at 170 (Comm. Print 1976).[27] "Where Congress includes limiting

ERISA Conf. Rep. at 5079. When coupled with the Conferees' earlier statement with respect to the guaranteed benefit policy exemption and the failure to refer to general or separate accounts, there can be little doubt that Congress envisioned circumstances where insurers would be deemed fiduciaries with respect to general account contracts.

[27] Hancock and the insurance industry have argued in the court below and elsewhere that a footnote in a "staff summary" stating that the intent of the House and Senate bills was the same justifies ignoring the different language chosen by the Conference Committee. *See, e.g.*, Goldberg & Altman, "The Case for Nonapplication of ERISA to Insurers' General Account Assets," 21 Tort & Ins. L.J. 475 (1986) (the authors are members of the ACLI's Fiduciary Task Force). Apart from the fact that this argument stretches "legislative history" beyond credulity, this Court has dealt with this same issue in connection with the preemption, savings and deemer clauses of ERISA, all of which changed drastically from their original incarnations in the House and Senate bills to their final form in the statute. *Metropolitan Life Ins. Co. v. Massachusetts*, 471 U.S. 724, 745 (1985); 29 U.S.C. §1144. This Court did not then, nor should it now, interpret the statutory language to mean the same thing as the radically different language that appeared in the original bills.

language in an earlier version of a bill but deletes it prior to enactment, it may be presumed that the limitation was not intended." *Russello v. United States*, 464 U.S. 16, 23-24 (1983).

The DOL says that the legislative history of §401(b)(2)(B) "does not shed light on what motivated the Conference Committee to rewrite the provision," and candidly acknowledges that it is guessing as to the "probable" goal Congress intended to accomplish with §401(b)(2)(B). U.S. at 20-21. As with the *Mack Boring* court, however, the DOL's interpretation dramatically expands the scope of the exemption, while ignoring the actual language chosen by Congress, and grants safe harbor protection to *all* general account contracts — whether or not they actually provide *any* fixed benefit payments — so long as they do *not* provide for variable benefit payments.

The DOL speculates that

> it is probable that Congress intended to accomplish only a rather modest tightening of the Senate proposal. Specifically, we believe that Congress most likely adopted the language in the definition of "guaranteed benefit policy" in Section 401(b)(2) in order to close a potential loophole that might have permitted insurers to avoid fiduciary responsibility while offering general account contracts that provided variable benefits to plan participants.

U.S. at 20. However, the "potential loophole" that the DOL claims that Congress may have intended to close — the sale of variable annuities from general accounts — is and since 1974 has been illegal under the laws of all fifty states. Hancock at 17, 19, n.30, 20, n.32; ACLI at 9, n.8, 11; NYMA at 4, n.3 ("only fixed benefit payments may be made from an insurer's general account.").

The DOL in essence postulates that §401(b)(2) was designed to address a problem which *did not exist* at time of the statute's enactment. Moreover, its divination of Congressional purpose,

finding no support either in statutory text or legislative history, is too speculative to be granted deference.[28]

B. *The Conference Report Makes Clear That Congress Understood That ERISA Would Require Substantial Changes In The Way Insurance Companies Do Business With Pension Plans and Pension Monies*

Hancock and *amici* argue at length that the legislative history contains no evidence that Congress recognized the disruptions which were likely to follow from application of §401(b)(2) to general accounts. Hancock at 33-35; U.S. at 21-22, 30; ACLI at 25. *See also Mack Boring*, 930 F.2d 267, 275 n.17 (3d Cir. 1991). This claim is refuted by the Conference Report:

> The Committee is aware that there exist *various established and recognized practices which are accepted in* commercial banking, trust and *insurance companies*, investment companies and other advisors in connection with employee benefit plans. However, notwithstanding current acceptance of such practices, the Subcommittee has found it difficult to establish definitive criteria concerning those practices which should be specifically proscribed. This difficulty was weighed . . . against the overriding need to protect workers' pension funds, and [the Committee] concluded that the latter's interest out-weighed any current attempt to define all practices and relationships which constitute not only actual but real potential threats to the security and preservation of the pension funds.

S. Rep. No. 127, 93d Cong. 2d Sess. (1974), *reprinted in* 1974 U.S.C.C.A.N. 4838, 4868 (emphasis added).

In keeping with this recognition, Congress undertook to lessen the burden upon insurance companies and others by providing lengthy transition periods and administrative procedures

[28] *See Mertens v. Hewitt Associates*, No. 91-1671, 1993 U.S. LEXIS 3742, at *9 (June 1, 1993); *Ardestani v. INS*, 112 S. Ct. 515, 520 (1991); *INS v. Cardoza-Fonseca*, 480 U.S. 421, 432 n.12 (1987); *Rubin v. United States*, 449 U.S. 424, 430 (1981).

pursuant to which affected parties can obtain relief. *See* 29 U.S.C. §§ 1108, 1114.

> [T]he Secretary of Labor is authorized by the Act to waive any proscribed practice as long as it is consistent with the purposes of the Act and determined to be in the interests of pension plan participants. *The Committee is not unaware of the possible impact of these prohibitions*, and accordingly has made provision in the bill for an adequate transition period of 3 years, or longer, if warranted.

S.Rep. No. 127, 93d Cong. 2d Sess. (1974), *reprinted in* 1974 U.S.C.C.A.N. 4838, 4868 (emphasis added); *see also* ERISA Conf. Rep., *supra*, at 5089-90 ("The conferees recognize that some transactions which are prohibited . . . nevertheless should be allowed in order not to disrupt the established business practices of financial institutions . . . consistent with adequate safeguards to protect employee benefit plans.").

In light of the many statements in the legislative history acknowledging the significant changes in insurance industry practices that would be required, Congress's failure to specifically enumerate each change is neither remarkable nor significant.[29]

[29] Ignoring the clear evidence of legislative intent, the ACLI relies upon *Levy v. Lewis*, 635 F.2d 960 (2d Cir. 1980), for the proposition that Congress did not intend to impose fiduciary status "when to do so would result in dual loyalties." ACLI at 24, n. 27. The primary basis in that case for the court's conclusion that an Insurance Superintendent fulfilling a statutory duty to liquidate an insurer is not an ERISA fiduciary was the court's recognition that the Superintendent "cannot be said to have exercised *discretionary* control over [an ERISA plan] when he was acting under a *statutory duty* to liquidate the assets of [the insurer] and cancel all of [the insurer's] outstanding contracts *as mandated* by the state court order of liquidation." *Levy*, 635 F.2d at 968 (emphasis added). Moreover, because the "plan" in *Levy* was unfunded, the court concluded that there were no "plan assets" as to which the Superintendent could be deemed a fiduciary. The other cases cited by the ACLI for this claim are equally inapposite.

III.

THE DEPARTMENT OF LABOR'S PRONOUNCEMENTS BELIE ANY NOTION OF SETTLED EXPECTATIONS; NO DEFERENCE IS DUE THE DEPARTMENT'S INTERPRETATION OF §401(b)(2)

The DOL contends before this Court that its consistently held position has been that ERISA's fiduciary rules do not apply to any general account contracts sold by insurance companies. In fact, the DOL has vacillated on this issue since ERISA's enactment. In any event, its current position is unsound.

A. *The DOL's Position is Not Entitled to Deference From This Court*

The DOL argues that this Court should defer to its interpretation of the term "guaranteed benefit policy." The DOL's interpretation, however, is not entitled to such deference, for several reasons.

First, as discussed previously, the DOL's interpretation of §401(b)(2) cannot be squared with the statutory language.[30] *Demarest v. Manspeaker*, 498 U.S. 184, 190 (1991) ("administrative interpretation of a statute contrary to language as plain as we find here is not entitled to deference"); *Public Employees Retirement Sys. v. Betts*, 492 U.S. 158, 171 (1989) ("of course, no deference is due to agency interpretations at odds with the plain language of the statute itself. Even contemporaneous and longstanding agency interpretations must fall to the extent they conflict with statutory language.").

Second, even if this Court determines that § 401(b)(2) is ambiguous, the DOL's interpretation is not entitled to deference because it effectively renders the "to the extent" language of the statute a nullity, given the DOL's professed belief that all general account contracts containing optional annuity purchase provisions are exempt from ERISA's fiduciary rules. "Where an agency's

[30] One district court has correctly pointed out that if IB 75-2 was intended as a complete exemption for all general account contracts, it exceeded the DOL's authority because such an interpretation contradicts the plain meaning of the statute. *Jacobson v. John Hancock Mut. Life Ins. Co.*, 655 F. Supp. 1290, withdrawn pursuant to settlement, 662 F. Supp. 1103, 1110 (D. Conn. 1987).

interpretation would deprive a statutory provision of virtually all effect, a court should not affirm the agency's interpretation absent 'legislative history of exceptional clarity.' " *American Fed'n of Gov't Employees v. F.L.R.A.*, 798 F.2d 1525, 1529 (D.C. Cir. 1986), *quoting American Fed'n of Gov't Employees, Local 2782 v. F.L.R.A.*, 702 F.2d 1183, 1187 (D.C. Cir. 1983).

Third, the DOL's interpretation of §401(b)(2) is not entitled to deference because it clearly is a recently adopted position first espoused in this Court, and unsupported by prior regulations, rulings or administrative practices. *See* discussion at Sections B-D, below. The *post hoc* nature of the DOL's most recent position is demonstrated by its inability to accept the Second Circuit's invitation in this case to submit an *amicus* brief.[31] The DOL seeks to explain this failure by reference to the "complicated" facts[32] and statutory language which is "not crystal clear," and concedes that "subjecting general account assets to regulation under ERISA concededly would have some advantages for plan participants and beneficiaries." U.S. at 29, n.17. If, however, it had been the DOL's "consistent interpretation" of §401(b)(2) since 1975 that all funds invested in insurance company general accounts are not "plan assets," U.S. at 9, then presenting this position to the Second Circuit would have been a simple matter.

[31] The DOL initially accepted the invitation, stating:

> *The Secretary has not formulated a final position* on the issues presented by this case. Because of the case's importance and complexity, the Secretary needs more time to adequately examine the relevant statutes, regulations, and the legislative and regulatory history in order to reach a final conclusion.

See DOL Motion dated March 3, 1992, docketed March 5, 1992 (emphasis added); *see also* P.A. 3. However, at the end of a nearly three-month extension granted by the circuit court for the DOL to file its brief, the DOL declined the court's invitation, stating the "need to fully consider all of the implications of these issues within the Department precludes our providing the Court with a brief within a foreseeable time frame." P.A. 3.

[32] It has never been disputed by any party to this litigation that GAC 50 is a general account group annuity contract, and the parties long ago stipulated to its essential characteristics.

B. *The History and Scope of Interpretive Bulletin 75-2 Do Not Support the DOL's Interpretation*

In construing §401(b)(2), the DOL purportedly relies upon "Interpretive Bulletin Relating to Prohibited Transactions 75-2" ("IB 75-2"), an early DOL pronouncement regarding application of ERISA's Prohibited Transaction provisions.[33] Hancock and *amici* argue that IB 75-2 exempted general account contracts from all ERISA fiduciary duty rules and was not limited to prohibited transactions. Hancock at 38; U.S. at 11, 26-27; ACLI at 27-29; LICONY at 22, n.8.[34] However, as the Second Circuit pointed out,

> the preamble to the [Plan Asset] regulation recites that IB 75-2 was issued "with respect to whether a party in interest has engaged in a prohibited transaction with . . . a corporation or partnership . . . in which the plan has invested."

P.A. 13.[35]

Hancock and *amici* argue that the DOL could not and did not intend to make a distinction between prohibited transaction rules – §406 and §408 – and the general fiduciary rules – §404. *Compare* 29 U.S.C. §1104 and §§ 1106, 1108. The Second Circuit rejected this argument: "There is no inconsistency in considering

[33] 29 C.F.R. §2509.75-2(b) (P.A. 97) (orig. publ. Feb. 6, 1975, republished without change to paragraph (b) on Nov. 13, 1986, 51 Fed. Reg. 41262, 41280). IB 75-2 has never been published for notice and comment pursuant to the Administrative Procedure Act's rulemaking provisions and thus does not have the force of law. *See* 5 U.S.C. §553.

[34] Curiously, the broad language of IB 75-2 on its face goes well beyond even the DOL's current interpretation of §401(b)(2). If IB 75-2 was indeed intended, as the DOL now contends, to amplify upon the scope of §401(b)(2), it must be rejected since the Bulletin would exempt even a general account contract which provided for *variable* benefit payments. Thus, as construed by the DOL, IB 75-2 would undo even the "rather modest tightening" the DOL claims Congress "probably" intended in the final version of §401(b)(2). U.S. at 20.

[35] Discussing the differences between IB 75-2 and its final plan asset regulation, the DOL in 1986 stated that the plan asset regulation was broader because it determined the reach of all of ERISA's fiduciary responsibility requirements, not just the prohibited transaction rules. Final Regulation Relating to the Definition of Plan Assets, 51 Fed. Reg. 41262 (No. 219) (Nov. 13, 1986).

certain assets to be plan assets for general fiduciary purposes but not for prohibited transaction purposes." P.A. 13.[36] The Second Circuit adopted the reasoning of *Associates in Adolescent Psychiatry, S.C. v. Home Life Ins. Co.*, in which the court rejected the contention that IB 75-2(b) grants issuers a complete exemption from ERISA:

> It seems perfectly consistent to this Court that plan assets might be considered such for purposes of general fiduciary duties, but not for purposes of the prohibited transactions rules. For example, without the policy stated in the bulletin, independent investment transactions between an insurer and large corporate employers who had purchased the insurer's general account products through a multiemployer plan could be deemed unlawful under §406 – even though there would be little, if any, chance that one employer could influence the insurer's investment decisions. Nevertheless, *it could still be sound statutory policy to subject the insurer to fiduciary duties more generally, while exempting it from the per se conflict-of-interest prohibitions of §406.*

729 F. Supp. 1162, 1184-85 (N.D.Ill. 1989), *aff'd*, 941 F.2d 561 (7th Cir. 1991), *cert. denied*, 112 S. Ct. 1182 (1992) (citations omitted) (emphasis added).

C. *The "Plan Asset" Regulation*

The history of the plan asset regulation, 29 C.F.R. §2510.3-101 ("PAR"), reveals that the DOL has never been convinced by the

[36] Nothing in the testimony of Mr. Fasser of the DOL, cited by Hancock and *amici*, contradicts the court of appeals' reading of the bulletin. In fact, Mr. Fasser's testimony focusses entirely upon prohibited transactions. *See also* Prohibited Transaction Class Exemption 75-1, 40 Fed. Reg. 50845 (Oct. 31, 1975) ("The fact that a transaction is the subject of an exemption granted under section 408(a) of ERISA . . . does not relieve a fiduciary of a plan to which the exemption is applicable from certain other provisions of ERISA, including . . . the general fiduciary responsibility provisions of §404 of ERISA which, among other things, require a fiduciary to discharge his duties with respect to the plan solely in the interest of the plan's participants and beneficiaries and in a prudent fashion in accordance with section 404(a)(1)(B) of ERISA").

insurance industry that ERISA's general fiduciary responsibility provisions should not apply to insurance company general account assets.[37] The proposed PAR was more far-reaching than IB 75-2 because it governed not only prohibited transactions but also the issue of what constitutes a plan asset and thus who is a fiduciary under ERISA. 51 Fed. Reg. 41262 (No. 219 Nov. 13, 1986).

The 1979 proposal would have given the insurance industry substantial relief, but was withdrawn by the DOL in 1985 and no similar provision has since been promulgated by the DOL.[38] Proposed Regulation Relating to the Definition of Plan Assets, 50 Fed. Reg. 961 (1985). In early 1985, Hancock and three other insurance companies, obviously concerned about the *Peoria* decision, submitted their comments on the DOL's new PAR proposal, requesting that the DOL include an explicit statement that assets held in general accounts pursuant to contracts with ERISA-covered plans are not plan assets and thus managers of such assets

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[37] 29 C.F.R. §2510.3-101 (preamble published at 51 Fed. Reg. 41262 (No. 219 Nov. 13, 1986)). This regulation resulted from regulatory process which began in 1979. 44 Fed. Reg. 50363 (Aug. 28, 1979) (proposed as 29 C.F.R. §2550.401b-1). Following a notice and comment period, the DOL offered a new proposal. 45 Fed. Reg. 38084 (June 6, 1980). In January 1985, the DOL withdrew the 1979 and 1980 proposals and promulgated a new proposal. 50 Fed. Reg. 961 (Jan. 8, 1985). A notice and comment period and hearing were held on the 1985 proposal. In April 1986, Congress ordered the DOL to adopt final regulations defining plan assets by December 31, 1986. 29 U.S.C. §1135(d). On November 13, 1986, the DOL did so. 29 C.F.R. §2510.3-101 (1986).

[38] The 1979 proposal stated in relevant part:

> [I]n the case of a plan which is funded in whole or in part by a contract or policy of insurance issued by an insurer, the assets of the plan shall incude the contract or policy under which the benefits are insured but shall not, solely by reasons [sic] of the issuance of such contract or policy, include the assets of the insurer issuing the contract or policy except to the extent that such assets are maintained by the insurer in one or more separate accounts and do not constitute surplus in any such account.

Proposed Regulations Relating to the Definition of Plan Assets and to Establishment of Trusts, 44 Fed. Reg. 50363, 50366 (1979) (to be codified at 29 C.F.R. pt. 2550 (proposed Aug. 29, 1979)). In light of the DOL's withdrawal of the 1979 proposal, Hancock's reliance upon it is ironic. *See* Hancock at 37, n.53; LICONY at 20-21.

are not fiduciaries.[39] The DOL declined to do so. In November 1986, the DOL adopted the final PAR, stating only that it was leaving IB 75-2(b) undisturbed. 29 C.F.R. §2510.3-101 (1986). This statement, ambiguous at best, was hardly the endorsement the industry sought. *Cf.* Hancock at 38, n.54; ACLI at 29.[40]

D. *Department of Labor Advisory Opinions*

The Second Circuit noted that two other statements of the DOL support its holding concerning §401(b)(2). In both cases, the DOL looked behind the labels "general account" and "separate account" in order to determine whether the "guaranteed benefit" exception should apply. DOL Advisory Opinion 78-8A (March 13, 1978); DOL Advisory Opinion 83-51A (September 21, 1983). The court concluded that these advisory opinions supported the notion "that the free funds in GAC 50 are plan assets as to which Hancock is an ERISA fiduciary." P.A. 11.

Advisory Opinion 78-8A states in relevant part:

> when an insurance company provides investment advice which determines the rate of return to the plan and its participants, the assets in the account shall constitute plan assets so that the insurance company is subject to the fiduciary provisions of the Act.

H.A. 107. Advisory Opinion 78-8A also states that IB 75-2 "was not intended to modify or alter the basic statutory scheme of Section 401(b)(2) of the Act." *Id.* The court below found that this advisory opinion demonstrated the DOL's concern that ERISA's fiduciary responsibility provisions apply to investment vehicles

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[39] Letter of Lawrence J. Hass, Esq. to DOL Office of Regulations and Interpretation, Office of Pension and Welfare Benefit Programs, dated March 11, 1985. (S.C.A. 562).

[40] LICONY argues at length that the PAR exempts general accounts from ERISA. LICONY at 4, 21-27. However, as the DOL points out, the PAR does not apply to matters within the scope of IB 75-2(b). U.S. at 19, n. 11; 29 C.F.R. §2510.3-101 (1986). Moreover, the DOL is without authority to craft a different and broader exemption for guaranteed benefit policies than §401(b)(2) provides, whether under the guise of a regulation or an interpretive bulletin. Thus, the "operating company" and debtor/creditor analysis of the PAR cannot be used to immunize general accounts.

providing a variable rate of return to plans, and noted that, as to "at least one component of GAC 50, Hancock's investment performance clearly does affect the amount of funds available to the plan and its participants". P.A. 11.

DOL Advisory Opinion 83-51A states in part:

> a conventional separate account (which holds contributions received from a plan and provides for the crediting of income on such amounts based upon the investment experience of the separate account) would not be considered to be maintained in connection with a fixed contractual obligation of the insurance company merely because assets of the separate account are ultimately applied to provide fixed annuities to participants, and the assets of such a separate account should be considered to be plan assets.

H.A. 112. From this opinion, the court below concluded that the DOL "appears to take the position that 'plan assets' for the purpose of the fiduciary responsibility provisions of ERISA do not lose their status as such merely because the ultimate use of the account may be to provide fixed annuities, where the plan assets are affected by investment performance." P.A 12.[41]

IV.

THE INSURANCE INDUSTRY'S UNSUPPORTED CLAIMS OF IMPOSSIBILITY CANNOT ALTER THE STATUTE'S MEANING; THE TRUSTEE'S INTERPRETATION ADVANCES ERISA'S GOALS

To paraphrase this Court:

> [This Court should] decline [Hancock's invitation] to misread [ERISA] in order to reach a sympathetic result when such a reading requires [the Court] to do violence to the plain language of the statute and to ignore much of the legislative history. Congress chose the language. . ., and Congress is free to change it.

[41] The DOL attempts to distinguish this advisory opinion by pointing to the differences between the contract there in issue and GAC 50. *See* U.S. at 28. The reasoning set forth in that opinion, however, is equally applicable to an analysis of general account contracts such as GAC 50.

Mansell v. Mansell, 490 U.S. 581, 594 (1989).

The insurance industry claims that the plain language of §401(b)(2) should be ignored or distorted beyond recognition because the enforcement of the statute as drafted by Congress would wreak havoc on the way insurance companies do business. The record, however, is devoid of any evidence of such dire consequences. Moreover, no effort has been made by the industry, the DOL or Hancock to use existing practices and procedures to harmonize the requirements of ERISA with the way insurance companies conduct their business. The need for federal protection of plan assets invested in insurance companies is clear, and the statute reflects a decision by Congress to afford such protection to pension plans and beneficiaries, despite any resulting disruption of insurance company practices.

A. *The Insurance Industry's Claims of Impossibility Ring Hollow; The Implementation of This Court's Decision Should Be Left to the DOL*

The insurance industry, through Hancock and *amici* ACLI, LICONY and the Insurance Commissioners, argue that compliance with both state insurance law and ERISA is "impossible," and that, therefore, the statute cannot mean what it says.[42] Hancock at 28-29; NYMA at 5-6, 13, 21-26; LICONY at 14-17. Notably, however, the DOL does not support this claim. Instead, the DOL states that crafting regulations and exemptions would be "difficult" (U.S. at 10, 24-25). As discussed previously, however, Congress weighed and accepted the implications of its actions (See Conference Report discussed at Point II, B, above).

The issue before this Court is not how §401(b)(2) should be implemented, but how it should be interpreted. Upon a decision of this Court affirming the decision below, the DOL will be required to develop a workable scheme for compliance that takes into account the needs of both the insurance industry and workers and retirees. It is with respect to such implementation strategies that the DOL should be given deference.

[42] There is of course no factual basis in this record for these arguments, nor was there any when the same arguments were raised below and in the Third Circuit.

Moreover, procedures have long existed to ameliorate any burden imposed upon the insurance industry from dual regulation. For example, insurance companies are currently permitted under state law to "segment" their general account assets, allocating the investment income from specific assets to particular lines of business. The power of segmentation in general accounts to provide the administrative tracking and accountability already available to trusts and separate accounts is clear from the description of segmentation that follows:

> By [segmentation], the insurer can allocate general account assets to various lines of business or to defined classes of contract holders by merely setting up and maintaining memorandum accounts. The segmentation must be carried out and maintained on an equitable and consistent basis . . .
>
> *Segmentation is a powerful and flexible tool for asset management and allocation of investment earnings.* It permits the matching of assets and liabilities in a way not possible under other approaches. Assets can be segmented in ways to meet the differing investment objectives of various groups of contract holders.

D. McGill & D. Grubbs, *Fundamentals of Private Pensions* 502 (6th Ed. 1989) (emphasis added).

While Hancock ignores segmentation in its brief, the ACLI argues that, in its present form, segmentation is inadequate to accommodate all of the requirements of dual regulation under state law and ERISA. ACLI at 23. It is not clear why Hancock, which already has segmented its general account into a variety of segments, including two pension-related segments (J.A. 98, ¶88), could not now create an ERISA-covered segment. Rules concerning such a segment could be reviewed and approved by the DOL.[43]

[43] The insurance industry points out that segmentation is only used to allocate income and expenses associated with specified assets and liabilities but that no assets are actually allocated to particular segments. This is a fictional distinction for every purpose except upon the insolvency of the insurance company. Under ordinary circumstances, specific assets are assigned to segments, and the investment income generated by these assets is allocated to the segment. However, upon insolvency, all assets are available to the liquidator to meet

(Footnote continued)

Because the insurance industry has steadfastly refused to accept the language of §401(b)(2), however, the availability of segmentation and similar devices to bring the industry into conformance with ERISA has gone largely unexplored. *Cf. Jacobson v. Hancock*, 655 F. Supp. at 1299 ("An insurer may not use a general account to harbor a plan's assets, create a potential conflict and thus claim relief from a fiduciary's obligations").

Moreover, Hancock and the insurance industry have also failed to explore specific mechanisms within ERISA which would have permitted Hancock to seek variances in order to minimize any disruptions to its business "consistent with adequate safeguards to protect employee benefit plans." ERISA Conf. Rep., *reprinted in* 1974 U.S.C.C.A.N. at 5090. Section 408 sets forth procedures under which exemptions from §406's Prohibited Transaction provision can be obtained from the Secretary of Labor. 29 U.S.C. §1108(a).[44] It would be administratively simple to convert IB 75-2 into a class exemption from §406 for the insurance industry. *Id.*; 29 C.F.R. §2570.30-.52 (1990).[45] Thus, it is meritless for Hancock to argue, without mentioning §408, that Congress could not have intended the disruption to insurance companies engendered by a proper interpretation of the "guaranteed benefit policy" exemption.

the liabilities of the company. It is difficult to believe that the DOL, the Pension Benefit Guarantee Corporation and the National Association of Insurance Commissioners could not develop a procedure to accommodate insolvencies. Moreover, "guaranteed benefits" would be subject to these same vagaries upon insolvency, a fact of which Congress was presumably aware in 1974.

[44] Under the applicable standards an exemption must be: (1) administratively feasible; (2) in the interests of the plan and of its participants and beneficiaries; and (3) protective of the rights of participants and beneficiaries of such plan. 29 U.S.C. §1108(a) (1992).

[45] Hancock, along with other insurers operating separate accounts, has complied since 1975 with dual regulation under ERISA and state insurance law with respect to group annuity contracts sold through separate accounts. The industry was required to meet ERISA's fiduciary responsibility requirements and to comply with extensive state regulations. *See, e.g.*, Separate Accounts and Separate Account Annuities, N.Y. Comp. Code R. & Regs., tit. 11A § 50.1-50.12. The industry has sought and obtained certain class exemptions for ERISA under section 1108(a). *See, e.g.*, PTE 81-82, 46 Fed. Reg. 46443 (1981). Individual insurance companies sought and obtained prohibited transaction exemptions with respect to specific transactions. *See, e.g.*, PTE 88-92, 53 Fed. Reg. 38, 798 (1988).

Indeed, it is pursuant to such administrative mechanisms that Hancock and other insurance companies have operated ERISA-covered pooled separate accounts. It should be noted that in the context of these pooled accounts, insurance companies have balanced the interests of many plans in the assets of these accounts. Apparently, no "irreconcilable conflicts" have arisen in the management of these accounts.

Finally, a simple expedient has always existed by which Hancock could have eliminated, or at least substantially reduced, any exposure it might have to the burdens of dual regulation. In 1988, Hancock finally agreed to an amendment to GAC 50 permitting the plan to withdraw the bulk of GAC 50's free funds from the general account. Although this withdrawal was subject to a market value adjustment, Hancock agreed to eliminate the other penalties previously attached to any transfer of funds, such as termination of the PA Fund, reversion of GAC 50 to a deferred annuity contract and the repurchase of the antiquated deferred annuities which were cancelled in 1968 (S.C.A. 519, ¶ 10; S.C.A. 559, ¶ 10). After Hancock agreed to this amendment, the plan transferred nearly $53 million to other funding vehicles (S.C.A. 561), thereby eliminating any potential conflict between state and federal law at least as to these funds. An expedient such as transfer of the "free funds," of course, could have been offered by Hancock long before 1988.

B. *Federal Protection For Non-Guaranteed Portions of General Account Contracts Advances ERISA's Goals*

The need for ERISA protection for funds not associated with guaranteed benefits is apparent in light of the treatment of insurance customers such as the Trustee under state insurance laws. The DOL recognizes this need: "[W]e recognize that a holding that assets held by insurance companies pursuant to contracts like GAC 50 are 'plan assets' would provide significant added legal protection against losses by pension plans, because ERISA imposes restrictions not currently provided by contract and insurance law." U.S. at 25-26.

The recent collapse of Executive Life Insurance Company and Mutual Benefit Life Insurance Company highlights the need for federal regulation of group annuity investment contracts like GAC 50. The history of these failures illustrates that state insurance

regulators have been unable to cope with the proliferation of investment vehicles sold by insurance companies under the rubric of "insurance." But for ERISA, additional insurance company failures could undermine pension plans upon which retirees and beneficiaries rely.

The risk of such failures is compounded by the limited scope of state guaranty laws. The Life Insurance Guaranty Corporation of New York Act is inapplicable to "[t]hat portion or part of any policy, contract or agreement under which the risk is borne by the holder thereof." N.Y. Ins. Law §7703(b)(2) (Consol. 1993). Massachusetts includes a similar provision in its Life and Health Insurance Guaranty Association Law. The protection of that guaranty association is not extended to

> (a) any portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policy or contract holder;
>
> * * *
>
> (c) any annuity contract or group annuity certificate that is not issued to and owned by an individual, except to the extent of any annuity benefits guaranteed to an individual by the insurer under any such contract or certificate.

Mass. Ann. Laws ch. 175, §146(B)(4)(B)(2) (Law Co-op. 1993).

Thus, in the event of Hancock's insolvency, both New York and Massachusetts will provide the protection of their guaranty funds *only* to the recipients of "guaranteed benefits" under GAC 50. In contrast, to the extent that the Plan's assets consist of "free funds," the Plan would be denied any recovery from the guaranty funds, reflecting the determination of the *amici* states that contracts like GAC 50 are indeed divisible, and that the contract in its "accumulation" phase is not entitled to relief.

The need for ERISA's protection is also illustrated by the district court's treatment of the Trustee's claims in this action. The Trustee has alleged far more than the mere technical violations of ERISA that Hancock mentions in its brief. The Trustee claims that Hancock engaged in a variety of improper practices, including:

a. the use of investment income properly attributable to GAC 50 and other older contracts to attract new business by inflating the investment return on new contracts during their first two years;

b. the allocation to GAC 50 of inflated expenses, in the form of investments in "Home Office" properties, in order to subsidize labor-intensive lines of business;

c. the use of GAC 50's pension funds to subsidize new business ventures, some speculative, designed to bolster other lines of business;

d. the over-compensation of Hancock through excessive charges and over-priced annuities; and

e. the refusal to permit the Trustee to use "free funds" for pension purposes or to withdraw such funds.

After the district court dismissed the Trustee's ERISA claims, Hancock moved for summary judgment as to the Trustee's claims that state law forbids these practices. The district court concluded that state law permitted such practices, which inarguably are prohibited under ERISA, and summarily dismissed all of the Trustee's state law claims. *Harris II*, P.A. 63-87. In light of the lack of state control of such practices, the need for ERISA fiduciary duty protection is clear.

V.

STATE LAW CANNOT AND DOES NOT PRE-EMPT ERISA; NEITHER THE McCARRAN-FERGUSON ACT NOR THE SAVINGS CLAUSE IS TO THE CONTRARY

Hancock and *amici* other than the United States contend that state insurance laws pre-empt ERISA. Hancock at 30-31; NYMA at 10-11. Their arguments are without merit. Neither the McCarran-Ferguson Act, 15 U.S.C. §1012(b), nor ERISA's Savings Clause, 29 U.S.C. §1144(b), mandates or permits such pre-emption.

Hancock's argument on this aspect of the case is rejected by the United States. Its brief states:

> We do not think, however, that the McCarran-Ferguson Act, 15 U.S.C. 1011 *et seq.*, precludes the application of ERISA to an insurer's actions under a general account contract, and leaves regulation exclusively to the States. That argument was correctly rejected by the district court. Pet. App. A27-35. . . . ERISA, both in general and in the guaranteed benefit policy provision in particular, *obviously and specifically relates to the business of insurance*. . . . Moreover, dual regulation under ERISA and state law is not an impossibility. Many requirements are complementary, and in the case of a direct conflict, *federal supremacy principles require that state law yield*. Pet. App. A29-31.

U.S. at 23, n.13. Hancock's argument was also rejected by the district court and it was not raised by Hancock before the Second Circuit. *Harris I*, P.A. 26-35.

A. *To the Extent that State Insurance Laws Conflict with ERISA, They Are Preempted*

1. *The Statutory Scheme*

ERISA contains a broad pre-emption provision:

> Except as provided in subsection (b) of this section, the provisions of [ERISA] shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan . . . .

29 U.S.C. §1144(a). The "savings" clause of ERISA provides:

> Except as provided in subparagraph (B), nothing in this title shall be construed to exempt or relieve any person from any law of any State which regulates insurance, banking, or securities.

29 U.S.C. §1144(b)(2)(A).[46]

Section 1144 requires a three-part analysis of each state law that might be affected by ERISA in order to determine whether the *state law* survives. The analysis never bears on the question of whether ERISA survives, as argued by Hancock. *See Pilot Life Ins. Co. v.*

[46] Hancock and *amici* argue that the "savings" clause indicates Congress's intent to exempt general accounts from ERISA. ERISA §1144(b)(2)(A). *See, e.g.*, U.S. at 23; ACLI at 24-25; LICONY at 13-14, 18. However, the "savings" clause indicates only the intention of Congress not to allow insurance companies to escape state regulation as a result of the statute's broad pre-emption provision.

Dedeaux, 481 U.S. 41, 44 (1987) ("*Pilot Life*").[47] Its only function is to determine whether a *state* law or regulation of the insurance industry stands or falls, and is irrelevant in this case because the only issue here is whether ERISA applies, which it clearly does.[48]

2. *The Pilot Life Analysis*

Hancock and *amici* fail to heed this Court's *Pilot Life* decision holding that where a state law might arguably "regulate[] insurance" and would be "saved" from preemption under ERISA's savings clause but would also undermine a clearly expressed intention of Congress in enacting ERISA, the state law is preempted. 481 U.S. 41, 52-56 (1987). Congress clearly expressed its intention to regulate contracts other than "guaranteed benefit policies," and to impose ERISA's fiduciary responsibility provisions upon the insurance industry; therefore, any contrary state laws must yield. 29 U.S.C. §1101(b)(2)(B).

[47] *See also Gelzinis v. John Hancock Mut. Life Ins. Co.*, No. 93-0569, 1993 U.S. Dist. LEXIS 5483 (E.D. Pa. Apr. 26, 1993) (where Hancock successfully argued that Pennsylvania's insurance bad faith statute was pre-empted by ERISA); *Dodd v. John Hancock Mut. Life Ins. Co.*, 688 F. Supp. 564, 572 (E.D. Cal. 1988) (where Hancock successfully argued that plaintiff's claims for punitive damages under California Insurance Code §790.03(h) were preempted by ERISA). Interestingly, in both *Gelzinis* and *Dodd*, Hancock prevailed by taking the very opposite of the position it has taken here.

[48] The analysis of whether a state law will be preempted by ERISA can be summarized as follows:

i) Pre-emption: Does the state law "relate to any employee benefit plan"? If not, the state law remains and no further analysis is necessary. If it does "relate," then the state law is preempted unless "saved" under the second and third steps. 29 U.S.C. §1144(a).

ii) Savings: Does the state law "regulate[] insurance, banking, or securities"? If it does not, the state law remains preempted and no further analysis is necessary. If it does, then no person is "exempt[ed] or relieve[d]" from compliance with the state law (*i.e.*, the state law is "saved"), unless there is a conflict under the third step. 29 U.S.C. §1144(b)(2)(A); *see also Union Labor Life Ins. Co. v. Pireno*, 458 U.S. 119, 129 (1982).

iii) Conflict: If the state law both relates to any employee benefit plan and regulates insurance, banking or securities, does it conflict with any provisions of ERISA? If not, then both ERISA and state law will be enforced. If the state law conflicts, then ERISA preempts the state law. *Pilot Life*, 481 U.S. at 51-57.

In *Pilot Life*, this Court was asked to determine whether Mississippi's common law of bad faith could be invoked by a plan participant in an action against the provider of an insured group health policy sold to an ERISA-covered employee benefit plan. The Court held that the common law claim could not be enforced because it afforded remedies, such as punitive damages, intentionally excluded by Congress from ERISA. *Pilot Life*, 481 U.S. at 54.

The Ninth Circuit, interpreting *Pilot Life*, held that a California Insurance Code provision (§790.03) which permitted private rights of action for "unfair insurance practices," including claims for compensatory and punitive damages, was preempted by ERISA. *Kanne v. Connecticut General Life Insurance Co.*, 867 F.2d 489, 493-94 (9th Cir. 1988), *cert. denied*, 492 U.S. 906 (1989) ("*Kanne*"). The court assumed without deciding that the law in issue "regulate[d] insurance" within the meaning of the savings clause. *Id.*

> Nevertheless, under *Pilot Life* we find the conclusion inescapable that §790.03(h) is preempted by ERISA.
>
> * * *
>
> We do not find it possible to read this language [from *Pilot Life*] in a way that permits a state statute like §790.03(h) to supplement the ERISA civil enforcement provisions available to remedy improper claims processing.

Kanne, 867 F.2d at 494. *See also Donatelli v. Home Ins. Co.*, 992 F.2d 763 (8th Cir. 1993).

Thus, a valid state regulation of insurance will be preempted by ERISA, despite the savings clause, if the regulation conflicts with the clearly expressed intention of Congress in enacting ERISA.

3. *McCarran-Ferguson Act*

Hancock and *amici* argue that McCarran-Ferguson applies independently of the Savings Clause through ERISA §514(d), which

provides that ERISA's Title I should not be construed to supersede any federal statutes. 29 U.S.C. §1144(d); Hancock at 31. However, McCarran-Ferguson's preservation of state insurance law does not apply where a federal statute "specifically relates to insurance," as ERISA clearly does. U.S. at 23, n. 13; 15 U.S.C. §1012(b); *U.S. Dep't of Treasury v. Fabe*, 113 S. Ct. 2202 (1993); *Pilot Life*, 481 U.S. at 51-57.

Congress' declaration of policy in the McCarran-Ferguson Act explicitly stated that the purpose of the Act was to prevent application of federal regulation to the business of insurance and preemption of state law in that field by the courts *except* where Congress has explicitly stated its intention to regulate in the area. The declaration of policy provides that "*silence* on the part of Congress shall not be construed to impose any barrier" to state regulation of the business of insurance. 15 U.S.C. §1011 (1988) (emphasis added). As set forth above, Congress clearly and explicitly has regulated the insurance industry by including its contracts and policies and the assets that support them among plan assets subject to ERISA's stringent fiduciary duty requirements. See 29 U.S.C. §401(b)(2)(B). Moreover, the McCarran-Ferguson Act "is to be narrowly construed in the face of valid federal regulatory interests: accommodation of federal and state regulatory interests is to be sought." *SEC v. Republic Nat'l Life Ins. Co.*, 378 F. Supp. 430, 436 (S.D.N.Y. 1974).

In sum, to the extent ERISA specifically conflicts with state insurance law, such state law is preempted under the analysis mandated by *Pilot Life*, the Supremacy Clause and the McCarran-Ferguson Act. *Pilot Life*, 481 U.S. at 51-57; 15 U.S.C. §1012(b); 29 U.S.C. §1144(a), (b), (d).

B. *Where ERISA and State Insurance Law Are Consistent, Hancock Is Subject to Dual Regulation*

Hancock's argument that state insurance law preempts ERISA is not new; it was rejected over ten years ago by the Court of Appeals for the Seventh Circuit in *Chicago Board Options Exchange, Inc. v. Connecticut General Life Insurance Co.*, a case

directly on point which Hancock does not cite. 713 F.2d 254 (7th Cir. 1983) ("*Chicago Board*"). In *Chicago Board*, Connecticut General's argument, identical to Hancock's here, was dismissed as baseless. The court reasoned:

> That ERISA does not relieve insurance companies of the onus of state regulation does not mean that Congress intended ERISA not to apply to insurance companies. Had that been Congress' intent we are sure that ERISA would have directly stated that it was preempted by state insurance laws. *Congress clearly intended that insurance companies be subject to dual regulation, at least as long as federal and state regulations do not conflict.*

Id. at 260 (emphasis added); *see also N.A.A.C.P. v. American Family Mut. Ins. Co.*, 978 F.2d 287, 295 (7th Cir. 1992).

The only relevant case upon which Hancock relies in fact supports the Trustee. In *Metropolitan Life Insurance Co. v. Massachusetts*, petitioner Metropolitan Life was seeking to escape a Massachusetts insurance law provision which required minimum mental health benefits in all group health insurance policies for Massachusetts residents. 471 U.S. 724 (1985). This state law did not conflict with any ERISA requirements; thus the Court never faced that issue in *Metropolitan Life*. *Id.* at 732 ("ERISA . . . contains almost no federal regulation of the terms of benefit plans").

Metropolitan Life merely holds that ERISA-covered plans which purchase group health policies from insurance companies are governed by both ERISA and state insurance mandated minimum benefit laws. *Metropolitan Life*, 471 U.S. at 747. Thus, while self-insured plans are subject only to ERISA, plans which purchase benefits from insurance companies are subject to both ERISA and state insurance law. *See* 29 U.S.C. §1144(b)(2).[40]

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[40] The balance of the cases cited by Hancock and *amici* are inapposite. All conclude that the state law at issue was not preempted; however, none hold that ERISA therefore does not apply.

It is clear that state insurance laws and ERISA can and do co-exist. Since 1975, the states and the federal government have regulated insurance company separate accounts without apparent difficulty. *See e.g.*, N.Y. Ins. Law §4240 (Consol. 1993); N.J. Admin. Code tit. 17B §28-1 to 28-15 (1992); "Separate Accounts and Separate Account Annuities," N.Y. Comp. Codes R. & Regs. tit. 11A §50 (1971); "Market Value Separate Accounts Funding Guaranteed Benefits; Separate Accounts Operations and Reserve Requirements," N.Y. Comp. Codes R. & Regs. tit. 11B §97 (1990). In the context of separate accounts, the insurance industry has made ample use of the administrative procedures that ERISA provides. *See*, *e.g.*, PTE 81-82 and 88-92, *supra* at n. 46.

CONCLUSION

For all of the foregoing reasons, Respondent Harris Trust and Savings Bank, as Trustee of the Sperry Master Retirement Trust, No. 2, respectfully requests that the decision of the Court of Appeals be affirmed.

Dated: July 9, 1993

Respectfully submitted,

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